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Business Efficiency in Small and Medium Enterprises In Selected Districts In Western Uganda.

Dr. Turyahebwa Abanis. * Senior Lecturer Kampala International University (KIU)

Email: abanis@accamail.com

Dr. Sunday Arthur. Senior Lecturer Kampala International University

Dr. Eliab Byamukama. Senior Lecturer Kampala International University

Dr. Aluonzi Burani. Senior Lecturer Kampala International University

Dr. Yahaya Ibrahim. Senior Lecturer Kampala International University

Dr. Sumil Novembrieta. DVC College of Higher Degrees and Research KIU

Abstract

The study was undertaken to determine the level of business efficiency in Small and Medium Enterprises (SMEs) in selected districts in Western Uganda. The study was guided by the following objectives; to determine the level of business efficiency of SMEs in terms of, profitability, growth; The study employed ex-post facto or retrospective and prospective designs together with descriptive design and descriptive comparative as well as correlation design. 335 questionnaires were distributed to respondents and were collected and used for analysis. The study found out that majority of SMEs owners (52%) in western Uganda are female, more than 69% of the SMEs owners are in their early adult hood and majority of the SMEs owners are high school leavers (30.1%), over 50% of the SMEs are sole proprietorship businesses and majority of the SMEs (42.4%) have been in business between 1-4 years. The study found out that the level of profitability among SMEs was high (Average Mean = 2.67), the results also showed that the level of growth in SMEs is low (Average Mean = 2.30). the overall findings showed that the level of business efficiency is low among SMEs (Average Mean = 2.48). The study employed the theory of Pecking Order (Myers 1984) which states that Management has a preference to choose internal financing before external financing, was proven in this study in the aspects of SMEs using internally generated funds as compared to borrowed funds. The recommendations from the study included; The SMEs owners should try to maximise and put to use their assets so as to obtain higher returns on assets. The government, more specifically the Ministry of East African Affairs, URA should sensitize the owners of SMEs on the opportunities that are available in the EAC and how the SMEs can be able to export their products to the neighbouring countries so as to boost their turnover. The owners of SMEs should have sales team in place so as to market the products and services of the business in order to increase sales. The SMEs owners should also make sure that business plans are prepared so as to act as a roadmap on how to take the business to the next level.

Key Words Business Efficiency, SMEs, Profitability, Growth

Introduction

Micro, Small and Medium Businesses (MSMEs) are generally regarded as the “backbone of the economy” (Kirby, 2003). These businesses constitute a majority of the economic growth and development that is derived. The Ugandan economy has made significant recovery since 1987, and is on the way to sustainable growth and development. This is being made possible by prudent policies that have been consistently pursued for the last 15 years towards economy liberalization and support for the private sector.

The term SMEs covers a wide range of perceptions and measures, varying from country to country and between the sources reporting SME statistics. Some of the commonly used criteria are the number of employees, total net assets, sales and investment level. However, the most common definitional basis used is employment, but, there is a variation in defining the upper and lower size limit of an SME (Ayyagari, Beck & Demirguc-Kunt, 2003).

Recent evidence shows that Small and Medium Enterprises (SMEs) form the bulk of Uganda’s private sector. If Uganda is to become competitive through growth of the private sector, it is inevitable that more attention must be paid to addressing the key bottlenecks to SME growth and competitiveness (MFPED 2008). Access to, and

* Dr. Turyahebwa Abanis, Head of Department Business and Public Administration, KIU-WC. E-mail: abanis@accamail.com,

costs of finance are reported to be a severe problem for SMEs in Africa. Good financial management practices have been viewed as critical elements in the business efficiency of SMEs in Uganda.

SMEs are making positive contributions to economic growth and development in Uganda, although the rate of failure is also high (Kazooba, 2006). The performance of SMEs in terms of profitability and growth are in most cases hindered by little attention given to areas that influence business efficiency.

Lack of effective management during SMEs early stages is also a major cause of business failure for small businesses. Owners tend to manage these businesses themselves as a measure of reducing operational costs. This study uncovered the example of business person who locks the shop for a full day whenever he goes shopping in Kampala. He does this once every week, a total of four days a month. One result of this is loss of customer loyalty. This is clearly explained by Katuntu's remarks that poor location of business, lack of management experience, and over-investment in fixed assets has led to the collapse of many businesses (Kazooba 2006). Inefficient financial management may damage business efficiency and this will continuously affect the growth of the Small and Medium enterprises. However, efficient financial management is likely to help SMEs to strengthen their business efficiency and, as a result, these difficulties can partly be overcome.

Recent evidence shows that Small and Medium Enterprises (SMEs) form the bulk of Uganda's private sector. If Uganda is to become competitive through growth of the private sector, it is inevitable that more attention must be paid to addressing the key bottlenecks to SME growth and competitiveness (MFPED, 2008). A large number of business failures in Uganda have been attributed to inability of financial managers to plan and control properly the current assets and current liabilities of their respective firms (Mbaguta, 2002).

Micro, small and medium scale enterprises (MSMEs) in Uganda face unique problems, which affect their growth and profitability and hence diminish their ability to contribute effectively to sustainable development (Harper 1974; ILO 1989; House, 1991). Indeed, in some cases these problems are so challenging that MSMEs are unable to address them at all, which in turn threatens their survival, growth and competitiveness. In other cases, it is the inappropriate handling of these obstacles that causes SMEs to fail.

Hindrances that affect the performance of SMEs, their competitiveness and survival include limited information on financing options, inadequate and expensive supply of utilities and limited access to networks that are needed to enhance competitiveness (Hatega, 2007; Kigozi, 2009). SMEs in Uganda are currently being faced with many serious difficulties such as shortage of capital for expanding and renovating equipment and technology, low productivity and competitiveness, lack of experience in terms of marketing, production management, and financial management.

According to Ssempebwa (1992), the management problems of SMEs stem from factors such as poor record keeping, insufficient training and decision-making not informed by sound analysis. Furthermore, most of these enterprises operate without systems in line with good financial management practice such that the owner-worker-manager is the sole decision maker and his/her absence leads to a halt in decision making.

Literature Review

Business Efficiency

Business Efficiency is a situation in which an organization maximizes benefit and profit, while minimizing effort and expenditure. For the case of this study, business efficiency is defined in terms of profitability, growth (Cummins 2003). The lack of efficiency affects all businesses whether small or big. Inefficiencies in larger businesses may go unnoticed due to the availability of excess resources. Smaller businesses may not survive or fail to grow due to the inefficiencies regardless of the nature of the business. In the study done in Ethiopia, the key challenges to the long term survival and viability of small businesses and enterprises are lack of basic entrepreneurial and managerial skills, poor efficiency, lack of access to finance required for growth and development, lack of relevance of the vocational curriculum to technical and managerial skills that are required by entrepreneurs in Ethiopia, lack of accurate information related to the risk of lending money to small businesses, and over-regulation of the small businesses sector in Ethiopia (Zeke, 2009).

The key challenges to the long term survival and viability of small businesses and enterprises are lack of basic entrepreneurial and managerial skills, poor efficiency, lack of access to finance required for growth and development, lack of relevance of the vocational curriculum to technical and managerial skills that are required by

entrepreneurs, lack of accurate information related to the risk of lending money to small businesses, and over-regulation of the small businesses.

Lerner and Wulf (2007) have shown that there is a significant association between the managerial efficiency of small firms and long-term survival, profitability and viability. The acute shortage of finance experienced by small businesses is a result of lack of efficiency in the management of development finance. There is a long-term strategic benefit in financing today's small enterprises through appropriate support strategy. Efficient managerial and technical skills are critical for the sustained growth and development of small businesses and enterprises in Ethiopia (Decron and Krishnan, 2009). The lack of essentially needed managerial skills is a serious threat to the continued survival and profitability of small businesses in developing economies.

Efficiency in managerial and technical skills has enabled small businesses and enterprises to play a major role in the alleviation of poverty and job creation in several emerging market economies (Hauner, 2009). The Grameen Bank of Bangladesh (Dowla, 2005) has provided finance to MSMEs on easy terms since the early 1970s, and this assistance of finance has contributed significantly to the alleviation of poverty and job creation. The success achieved by Grameen Bank is attributed to visionary leadership, innovative thinking and managerial efficiency. (Woldehana et al., 2008).

Profitability

Profitability ratios are viewed as a way to identify and measure business efficiency of SMEs. According to Jaggi and Considine (1990), profitability is a crucial indicator for determining the financial position of the firm. The firm is considered financially weak when its profitability is sliding or the profitability is weak compared to other firms in the industry. In their study, they also used return on assets as the indicator to reflect profitability.

Burns (1985) and Meric et al. (1997) measured profitability by three ratios: return on total assets, return on net assets, and return on equity. According to Burns (1985) return on total assets is the best measure of a firm's efficient use of assets because it is independent of financing methods. While return on equity is a measure of the profit return to shareholders.

Profitability has generally been found to be lower for small enterprises than large in USA studies such as Anderson (1967), Gupta (1969), and the USA Small Business Administration (1984). Only Tamari (1980) and Walker and Petty (1978) found small enterprises to be more profitable than large enterprises. In the UK, only Bates (1971) found small enterprises to be less profitable than large enterprises. Both Bolton (1971) and Wilson (1979) found that small enterprises were more profitable than large. Bolton (1971) also found that growth small enterprises were more profitable than either large enterprises or other small enterprises.

In more recent, Davidson and Dutia (1991) also found smaller firms in their study tend to have lower profit margins than large firms. However, small firms did not have lower ROA ratios. Conversely, Osteryoung, Constand and Nast's (1992) results of studying indicated that two profitability ratios, return on sales and return on net worth, are not different across the large and small firms.

Growth

Weston and Brigham (1981) consider the financial implications of five stages of development: formation, rapid growth, growth to maturity, maturity, and decline, and found that major sources of finance at formation are the owners' personal resources. However, according to McMahon et al. (1993) the major financial problems likely to arise at this stage are that these resources are insufficient and that the small enterprise is thereby under-capitalized. Growth beyond formation is likely to be financed by retained earnings, trade credit and bank borrowing. As a result, growth may have the following effects: growth may outstrip financial resources, leading to over-trading and liquidity crises; growth may also cause a financial gap where the small enterprise is forced to rely too much on short-term finance because of a lack of long term finance. Further growth may require a stock market flotation in order to overcome the finance gap.

When studying the effect of growth and size on financial characteristics, Gupta (1969) looked at variations in asset utilization, leverage, liquidity and profitability between manufacturing enterprises operating at different size levels

and with different growth rates. Gupta's (1969) findings are summarized as follows: activity ratios and leverage ratios decrease with an increase in the size of the enterprise but increase with the growth of the enterprise. Liquidity ratios rise with an increase in the size of the enterprise but fall with growth rates. Larger enterprises tend to have higher profit margins on sales than small enterprises.

Methodology

The study employed ex-post facto or retrospective and prospective designs, descriptive design, descriptive comparative, and descriptive correlation strategies were used. Data was collected using standardized questionnaires. A sample size of 386 respondents was computed using Slovic's formula out of a total of 10,730 SMEs in selected districts in Western Uganda. The retrieved questionnaires were 335 representing a retrieval rate of 87%. Cronbach's Alpha coefficient test indicated that the questionnaires were reliable since the coefficient was above 0.5 ($\alpha=0.903$). Respondents were selected using purposive sampling, systematic random sampling and simple random sampling to arrive at the desired sample of the owners of SMEs in selected districts in Western Uganda. Frequency and percentage distribution were computed and significant differences were determined with the computation of Analysis of Variance.

Findings

In this chapter, the answers to the specific objectives of this study are presented, analyzed statistically in tables and interpreted to elaborate on the findings based on the related literature and empirical studies.

Level of Business Efficiency (Profitability) in SMEs

Table 1: Level of Business Efficiency (Profitability)

Table 1
Level of Business Efficiency (Profitability)
(Item Analysis)
n=335

| Item | Mean | Interpretation | Rank |
|--|------|----------------|------|
| Profitability | | | |
| The business is profitable | 3.34 | Very High | 1 |
| The current selling price is greater than cost price | 3.22 | High | 2 |
| The business income from sales always exceeds the expenses | 3.07 | High | 3 |
| The business objective is sales maximization | 2.89 | High | 4 |
| The rent costs are always lower as compared to sales | 2.86 | High | 5 |
| The business pays tax on profits | 2.69 | High | 6 |
| The business other objective is cost minimization | 2.55 | High | 7 |
| Utility bills, salaries, wages and finance costs are lower | 2.47 | Low | 8 |
| The business return on sales is always above 25% | 2.27 | Low | 9 |
| The business return on Assets is above 25% | 2.06 | Low | 10 |
| The business return on Equity is above 25% | 1.95 | Low | 11 |
| Average Mean | 2.67 | High | |

Source: Primary Data 2012

Legend

| Mean Range | Response Mode | Interpretation |
|------------|-------------------|----------------|
| 3.26-4.00 | Strongly agree | Very High |
| 2.51-3.25 | Agree | High |
| 1.76-2.50 | Disagree | Low |
| 1.00-1.75 | Strongly Disagree | Very Low |

The findings as per Table 1 revealed that majority of the SMEs are profitable (Mean = 2.67). This means that businesses are profitable though the way they are operated could hamper more profitability. The findings also showed that SMEs set their selling prices above the cost price (Mean = 3.22). This means that the SMEs leave a margin to enable them have a profit before their operating expenses. This is supported by the findings that the income from sales exceeds expenses (Mean = 3.07). Managers can increase corporate profitability by reducing the number of days of accounts receivable and inventories. Less profitable firms wait longer to pay their bills (Deloof, 2000). The findings revealed that some of the SMEs pays taxes on profits (Mean = 2.69). This is in addition to other indirect taxes that are paid on day to day activities including Value Added Tax.

The results also showed that majority of the SMEs objective is sales maximization (Mean = 2.89). This means that businesses aim at selling more at subsidized prices to increase turnover which leads to overall high profits. The findings further revealed that operating costs are considerably higher to sales (Mean = 2.47). These costs include utilities, salaries, wages, finance costs, among others.

The findings further revealed that the SMEs return on assets is low (Mean = 2.06). This means that SMEs are operating below capacity and the assets are not utilized fully to generate sales to enable the firms enjoy profitability. The findings also showed that the return on sales are considerably low (Mean = 2.27) and this clearly means that the SMEs are spending more to sell. This is probably due to high cost of sales which incorporates the cost of purchases, the cost of maintaining stock and this reduces the return expected which reduces the overall level of profitability. The findings further showed that the return on equity is low among SMEs (Mean = 1.95). As earlier seen, most of the SMEs finance their assets with internally generated funds and they do this with high expectation of getting returns. However, this is not true with the current findings since the return on owner's funds is low and this probably is among the reasons why some investors abandon their businesses and end up closing them. However, to increase profitability, earlier studies done by Shin and Soenen (1998) investigated a strong negative relation between cash conversion cycle and corporate profitability and the result indicates that managers can create value for their shareholders by reducing the cash conversion cycle to a reasonable minimum.

Table 2: Level of Business Efficiency (Growth) in SMES

The second construct under Business Efficiency was Growth. In order to obtain information, the owners of SMEs were requested to respond to various questions pertaining to level of growth among SMEs on a Likert scale of four where 1= strongly disagree, 2 = dis agree, 3 = agree and 4 = strongly agree. The results are presented in Table 2below.

Table 2
Level of Business Efficiency (Growth)
(Item Analysis)
n=335

| Item | Mean | Interpretation | Rank |
|---|------|----------------|-----------|
| Growth | | | |
| The customers prefer your to those of competitors | 3.22 | High | 1 |
| The customers are satisfied with our services/products | 2.93 | High | 2 |
| The business customers are retained | 2.92 | High | 3 |
| The business expects profits to increase by more than 40% this year | 2.81 | High | 4 |
| The business antispatates to have a sales increase by more than 40% this year | 2.80 | High | 5 |
| The business has motivated staff | 2.63 | High | 6 |
| The business has more than 25%of the market share | 2.58 | High | 7 |
| The business has a mission statement | 2.35 | Low | 8 |
| The business key performance indicators are reviewed regularly | 2.34 | Low | 9 |
| The number of employees have grown this year | 2.20 | Low | 10 |
| The business prepares forecast statements | 2.19 | Low | 11 |
| The business assets have grown by more than 30% this year | 2.12 | Low | 12 |
| The business has a sales team in place | 2.07 | Low | 13 |
| The business has clear key performance indicators | 1.91 | Low | 14 |
| The business has opened up new sales outlets | 1.90 | Low | 15 |
| The business carries out marketing research | 1.82 | Low | 16 |
| The business prepares a business plan | 1.77 | Low | 17 |
| The business exports products to neighbouring countries | 1.61 | Very low | 18 |
| The business has full market information | 1.54 | Very low | 19 |
| Average Mean | 2.30 | Low | |

Source: Primary Data 2012

| | | |
|-----------|-------------------|-----------|
| 3.26-4.00 | Strongly agree | Very High |
| 2.51-3.25 | Agree | High |
| 1.76-2.50 | Disagree | Low |
| 1.00-1.75 | Strongly Disagree | Very Low |

The means in Table 2 above clearly indicate that the level of business growth among SMEs was low (Average mean = 2.30). This is seen through the very low exports (Mean = 1.61) the SMEs are making to the neighbouring countries like Rwanda, DRC among other East African countries. The reasons for low exports is probably the quality of the goods produced as well as constraining resources required to export the goods. The findings also revealed that the businesses lack full market information (Mean = 1.54). This means that accessibility of information about new markets, customers needs among SMEs is very low and this reduces the chances of SMEs growing. The results also showed that SMEs do not carry out marketing research (Mean = 1.82). This means that the SMEs do not know where they are in terms of market needs, they do not know whether their customers desire modified products and this limits the growth rates. The findings further revealed that SMEs do not have clear performance indicators in place (Mean = 1.91) and this makes it difficult for the businesses to be evaluated on whether they are moving on the right track as per the earlier objectives set. Similarly, even the few that have key performance indicators in place, they do not review them (Mean = 2.34) to cross check with what is actually taking place and suggest possible way forward for the business to take.

The findings revealed that few of the SMEs prepare business plans (Mean = 1.77). This means that the SMEs have no road map on where they would like to be in the near future. This includes long term plans regarding expansion, new production/services to be introduced on the market, financing plans on whether to acquire loans or bring on board new shareholders and all these factors affect the growth of SMEs. The results also showed that SMEs do not have a sales team in place (Mean = 2.07). This means that the SMEs are likely to have constant sales or even declining sales as some of the customers may be taken by other competitors since there is no one in place to look for new customers as well as creating awareness about the products or services offered by the respective SMEs.

The findings also revealed that most of the SMEs assets are not growing (Mean = 2.12). This means that the business levels of growth are low and since the assets are not growing, then the wealth and return of investors is low as well and this makes the investors to take a lot of time to get their money invested in the business back after a long time. The findings further revealed that the majority of the SMEs remain with the same outlets and few only manage to expand through opening up new outlets. This is attributed to lack of resources to enable them open up, poor planning and lack of market information (Mean = 1.54). The findings also showed that the employees are not increasing in numbers (Mean = 2.20) in view of the few outlets that are opened up by the SMEs.

The results from Table 2 showed that few SMEs prepare forecast statements (Mean = 2.19). This indicates low levels of planning among SMEs which hinders growth. Similarly the findings showed that most of the SMEs do not have mission statements (Mean = 2.35) which means that the SMEs are operating largely as “Jua kali” businesses without any benchmark to act as a fall back position. However, some of the SMEs anticipating to gain some market share above 25% (Mean = 2.58), likewise some of the SMEs anticipating to have increased sales by the end of the year (Mean = 2.80) while others are expecting increased profits by 40% by the year end (Mean = 2.81). In this regard, some SMEs have motivated staff (Mean = 2.63) and they are dedicated to improving the operations of the SMEs. In general view on growth, Barkham, Gudgin, Hart and Hanvey (1996) adopted the methodological framework introduced by Storey (1994) in their study which investigated the success factors behind small business success in the UK between 1986 and 1990. They found that it was the characteristics of the entrepreneur and the business strategies adopted that mainly determined the growth of small firms. Their study concluded that the firms with higher growth rates were those managed by relatively young entrepreneurs who had other business interests, market focus, profit oriented, and were members of professional organizations. The findings further showed that the customers are satisfied with their products/services (Mean = 3.22) which enable the SMEs to retain their current customers (Mean = 2.92) and also the current customers prefer their products/services than those of their competitors (Mean = 3.22). However, this cannot be an everlasting situation if the SMEs do not put efforts to search for market information concerning customer’s needs as well as expanding their outlets in order to enable their businesses to grow to the desired levels.

Storey (1994) agreed with Duchesneau and Gartner (1990) that the following three categories of factors primarily have the greatest influence on the growth of small business: (1) The characteristics of the entrepreneur(s)/owner-manager(s), (2) The characteristics of the small firm. (3) The range of business development strategies. These three categories of factors require a homogenous well planned integration to achieve adequate growth. Another important finding of Storey's study stated that there was little evidence to the direct influence of the entrepreneurs' background on the growth of the small business.

Conclusion

Based on the findings of this study, the following conclusions were drawn:

The Theory of Pecking Order (Myers 1984) which states that Management has a preference to choose internal financing before external financing, was proven in this study in the aspects of SMEs using internally generated funds as compared to borrowed funds.

The study was able to bridge the gaps that were not covered by the previous studies since none of the studies had looked into business efficiency in SMEs in Uganda. The study brought up new knowledge on how SMEs apply financial management practices and the weaknesses that were found out in their current operations hindering their efficiency in terms of profitability and business growth.

The study revealed that the SMEs return on assets is low (Mean = 2.06). This means that SMEs are operating below capacity and the assets are not utilized fully to generate sales to enable the firms enjoy profitability. The findings also showed that the return on sales are considerably low (Mean = 2.27) and this clearly means that the SMEs are spending more to sell. This is probably due to high cost of sales which incorporates the cost of purchases, the cost of maintaining stock and this reduces the return expected which reduces the overall level of profitability.

The findings revealed that few of the SMEs prepare business plans (Mean = 1.77). This means that the SMEs have no road map on where they would like to be in the near future. This includes long term plans regarding expansion, new production/services to be introduced on the market, financing plans on whether to acquire loans or bring on board new shareholders and all these factors affect the growth of SMEs.

Recommendations

The SMEs owners should try to maximise and put to use their assets so as to obtain higher returns on assets. This will in the long run lead to increased sales if the assets are put to use. The owners of SMEs should also make sure that they set mission statements so as to keep them focused, they should also put in place key performance indicators and have these reviewed regularly in order to know the progress on whether they are being achieved or not.

The owners of SMEs should have sales team in place so as to market the products and services of the business in order to increase sales. The SMEs owners should also make sure that business plans are prepared so as to act as a roadmap on how to take the business to the next level.

The government, more specifically the Ministry of East African Affairs, URA should sensitize the owners of SMEs on the opportunities that are available in the EAC and how the SMEs can be able to export their products to the neighbouring countries so as to boost their turnover.

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